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One Minute Memo®

Executive Employment Agreement Causes Loss of Bonus Deduction

IRS Ruling May Also Affect 409A Elections

A recent private letter ruling by the Internal Revenue Service illustrates the importance of considering the ways in which executive employment agreements can interact with the company's incentive plans to affect the tax treatment of the executive's compensation. In this case, a public company was unable to deduct bonuses paid to the executive under §162(m) of the Internal Revenue Code. However, the ruling also has implications under §409A that will affect both public and privately held companies.

Code §162(m) generally prohibits a public company from deducting more than $1 million in annual compensation paid to its CEO and other proxy officers. There is an exception for qualified incentive compensation, and most public companies have adopted bonus plans that are intended to qualify for the §162(m) exception. In private letter ruling 200804004, the company had adopted such a §162(m) plan. However, an executive of the company had entered separately into an employment agreement that provided that if the executive were terminated without cause, or resigned for good reason, in the middle of a performance period, he would receive a pro rata share of his target bonus under the §162(m) plan for the period.

One of the requirements of qualified incentive compensation is that it is paid only if the performance goals are met, and because the employment agreement created the possibility that the executive could receive a portion of his bonus without the goals being met the IRS ruled that the bonus did not qualify under §162(m) *even though the executive was in fact not terminated.*

Private letter rulings are not binding on other taxpayers, and PLR 200804004 is arguably inconsistent with previous rulings issued by the IRS. However, private letter rulings can serve as a valuable guide to current IRS thinking, and this ruling should be considered by all companies (public or private) in negotiating the severance terms of their executive employment agreements. The following points should be considered:

- Although §162(m) applies only to public companies, a similar issue can arise under Code §409A for private companies (or non-proxy officers of a public company) if the company permits executives to voluntarily defer their bonuses. Normally §409A provides that deferral elections must be made prior to the beginning of the year or other performance period. A special rule allows deferral elections for qualified incentive compensation to be made up until six months before the end of the performance period, but if an executive's employment agreement entitles the executive to a share of his or her target bonus if the executive is terminated prematurely, the result may be to disqualify his or her deferral election (if made under the six month rule) and subject the executive to the 20% penalty tax under §409A.
- If the employment contract had provided (as many such contracts do) that, in the case of termination, the executive would receive a pro rata share of his or her bonus, but the bonus would be paid at the end of the performance period based on actual achievement of the performance goals, it appears that the bonus would not have been disqualified under either §162(m) or §409A.
- The §162(m) and §409A regulations both allow a target bonus to be paid in the case of death, disability or change of control. However, the regulations do not allow such payments in the case of other terminations.

The lesson of PLR 200804004 is clear—no matter how carefully a company's incentive plan is drafted to comply with §162(m) or other tax requirements, you must also take into account the collateral effect that individual employment contracts may have on the operation of the plan.

If you would like to discuss the IRS ruling and how it may affect your company's incentive programs, please call the Seyfarth Shaw attorney with whom you work, or any Employee Benefits attorney on our website, www.seyfarth.com

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